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LLC and "S" corporation: How are they alike and how are they different?

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When starting a new business, the owner(s) must decide on the form of business entity to use. Frequently this decision comes down to an "S" corporation or a limited liability company (LLC), both of which offer a pass-through tax classification - meaning they generally are not subject to an entity level tax. For income tax purposes, an "S" corporation is treated like a sole proprietorship if there is only one shareholder, or in many ways like a partnership if there are two or more shareholders. Likewise, for income tax purposes, single member LLCs are treated as disregarded entities, and multi-member LLCs are generally taxed as partnerships.

Still, despite the above described similarities, there are many differences between "S" corporations and LLCs.

Strict requirements are imposed for "S" corporations which, if breached, will disallow the "S" corporation election. These include: (i) all shareholders must be U.S. citizens or resident aliens, certain types of trusts, estates, or certain exempt organizations; (ii) the corporation may not have more than 100 shareholders (though spouses are not considered separate shareholders for the purpose of this rule); (iii) the corporation can only have one class of stock; and (iv) profits and losses must be distributed to the shareholders in proportion to their ownership interests.

Conversely, with an LLC, there are no restrictions on who may be a member. As such, nonresident aliens, corporations, and other LLCs, trusts, and other entities may all be members. And, unlike with "S" corporations, many different types of equity interests are allowed. Further, the members of the LLC have total discretion in allocating profits, losses, income, expenses, and credits between them as they wish, provided the allocation has "substantial economic effect." This allows the members to have different allocations of tax benefits (like depreciation and losses) without regard to their pro-rata ownership interests, unlike an "S" corporation which cannot do this.

Self-Employment Tax

(an SE Tax)

The distributions of profits made to "S" corporation shareholders are not subject to SE Taxes. Instead, only the income earned by the shareholders, that is, wages, salary, and compensation paid by the corporation for services provided by them, is subject to SE Taxes. With an LLC, on the other hand, its income flows through to its members (whether as salary or distributed profits), all of which will generally be subject to SE Tax.

Contributions and

Distributions of Property

For "S" corporations, contributions of appreciated property (including real estate) in exchange for shares of stock will not cause the recognition of taxable income on the exchange, provided that at least 80 percent of the outstanding shares of the corporation are owned by the person making the contribution following the transaction. Likewise, contributions of appreciated property to an LLC are generally tax-free; however, unlike with an "S" corporation, there is no ownership or control requirement.

For "S" corporations, distributions of appreciated property will trigger the recognition of corporate level gain, which must be allocated proportionately to its shareholders. Conversely, tax-free distributions of appreciated assets can be made by an LLC to its members, provided the member's adjusted basis in the LLC exceeds the balance of his or her capital account. As such, transfers of property into and out of an LLC are free of immediate tax consequences.

Basis and Debt

"S" corporation shareholders only receive basis in their shares for personal loans made directly to the corporation. They get no basis for any other type of entity level debt, even when personally guaranteed by the shareholders. LLCs, on the other hand, allow member-level tax basis adjustments for LLC liabilities, including an adjustment in the tax basis of the LLC's assets upon the sale of a member's interest. Therefore, an LLC can provide tax benefits that an "S" corporation cannot where the entity own real estate subject to debt. The LLC members are able to deduct more of the entity's tax losses as they occur, and they can also take advantage of their increased basis upon a sale.

Conclusion

Given the above, it is critical to remember the differences between "S" corporations and LLCs. Despite their similar pass-through tax classification, there can be significant differences in their overall tax treatment, which can cause substantial differences in tax liability - which is something not to be forgotten or ignored.

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